

CHAPTER 3: OPERATIONS

Overview

The retail and wholesale operation provides an important revenue source for the state. In FY 04 more than \$600 million in annual gross sales, licensing fees and producer taxes will be collected. More than 40 percent of that amount (\$245 million) will be returned to the state, cities and counties. This distribution is made *after* the cost to operate the agency has been deducted.

More than 40 percent of \$600 million in revenue collected in FY 04 will be returned to the state, cities and counties.

The state is the sole wholesaler and retailer of spirits through its state and contract liquor stores. Beer and wine are sold under a “three-tiered” system designed to create a stable market and discourage over-consumption. Under this system, producers sell to distributors who then sell to retailers at a mandatory 10 percent markup. All restaurants, clubs and businesses licensed to sell liquor by the drink must obtain their spirits through one of the 161 state stores. All packaged liquor sold at retail must be dispensed through a state or contract store.

Retail Services, Purchasing Services, and the Distribution Center have 690 budgeted FTEs. As stated in Chapter 2, the collective efforts of these divisions produce results that meet or exceed some private industry and other control state system results. There are a number of reasons for this success, including:

- A monopoly on spirit sales
 - Seasoned employees that are experts in the industry
 - A bailment inventory system that allows the agency’s Distribution Center to hold a large percentage of its inventory and not pay for product until it is shipped out to stores
 - The amount of taxes collected on sales
 - Good relationships with stakeholders and suppliers
 - Centralized distribution system
 - Lean staffing at state-operated stores
 - Commission formula for contract stores
 - The margins and large-scale of the operations
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Consistent with the agency's strategic goals, management continues to look for ways to increase the bottom line while maintaining high-quality customer service. In preparing this plan, teams of agency employees were asked to look for opportunities to improve business operations in the following areas:

1. Create revenue enhancement opportunities and best practices in retail operations by identifying sales growth opportunities, expense savings opportunities, or some combination of both for retail operations.
2. Create revenue enhancement opportunities and best practices in wholesale operations by identifying sales growth opportunities, expense savings opportunities, or some combination of both for wholesale operations.
3. Improve distribution and purchasing, with particular emphasis on how to favorably impact the Cost of Goods Sold.
4. Improve customer service and store presentation, with emphasis on in-store merchandising, design strategies and employee training programs.
5. Improve management tools and technology, with employees identifying management systems, reporting, quality control or corrective action tools for system improvements.

This business plan incorporates the best ideas and opportunities developed through the collective efforts of LCB staff, stakeholders, and other experts in the industry.

Retail Operations

A continuing key goal is to maximize revenues by operating more like a successful business. The revenue earned through improved retail and wholesale operations helps provide a stable base for the agency to carry out its public safety mission. Improving retail sales totals while maintaining high customer service requires a focus on basic best business practices. This represents a change in orientation for store employees, who have operated without a central planning model. Basic information needed to make many decisions and evaluate the profitability of individual stores has not been available. Retailing management expertise has been lacking.

Last biennium, a new management team came on board and began exploring ways to improve retail and wholesale performance. Many improvements have been made, but many more changes are needed to create a model wholesale/retail operation.

Based on recommendations by employee committees and intensive study by management staff, the following recommendations have the greatest potential to effect improved revenues.

1. **Relocate Six Under-Producing Stores**

There are many variables to consider in making store relocations, such as the net impact such decisions have on total sales, customer service and aggregate profitability. The following steps will be taken in making these decisions:

- Establish location performance standards for state-operated and contract stores.
- Conduct a review of all stores using these standards.
- Implement relocation strategies to improve performance at the least-profitable stores.

An example of a performance evaluation standard for a state store follows:

Revenue Return Ratio

Revenue generated by stores comes from taxes and markup assessed on each bottle sold. One way to gauge the success of a store is measure the store's aggregate sales against taxes collected, as shown in the diagram below.

$$\frac{\text{Taxes collected plus net profit or minus losses}}{\text{Sales for reporting period}} \quad (\text{divided by})$$

The resulting ratio is an indicator of a store's revenue generation. A 25 percent return is suggested as a minimum threshold, with some consideration given to a store that has disproportionate wholesale sales volume.

An additional performance indicator could be employed to help stores achieving only the minimum 25 percent return improve:

- **Average sales per square foot:** A minimum for review would be \$350 of sales per square foot. A next step would be to determine what could be done to increase this sales rate to at least \$400 per square foot via training or corrective action.
- **Sales to FTE ratio:** A minimum for review would be the average store's sales divided by the FTE count. If this minimum is not met, determine what could be done to increase sales per FTE via training, merchandising or other action.
- **Proximity to other state-operated or contract outlets and net revenue impact:** Determine if any other stores are within a five- to 10-mile radius of the store under review, with consideration given to whether it is in an urban or rural location and accessibility to licensee accounts. Assuming stores within five to 10 miles of a closed store will absorb a portion of the closed store's business, estimate the net revenue loss of the closure.

The strategy for relocations is to identify high-traffic locations that have similar customer demographics that would result in higher sales and revenue return. An example would be moving into existing locations next to grocery stores, or a mall where a grocery store is an anchor tenant.

The goal in this process is to make thoughtful decisions regarding what action(s) are most appropriate to take of all the stores in aggregate, with the end goal to maximize revenues and improve customer satisfaction.

2. Open Additional Retail Stores

The market trend data presented in Chapter 2 indicates there are opportunities to selectively expand by opening new stores, particularly in the state's highest-growth areas. As the data indicates, fewer stores are serving more people per capita than ever. In some areas, store capacity is stretched thin, particularly during peak buying periods. To meet this additional demand and to capitalize on growth niches, three new stores and two new concept stores are proposed for the 2005-2007 biennium.

3. Expand Store Personnel Training Program

The WSLCB must rely on in-store merchandising to market its products. One of the most direct ways and key to the agency's business strategy is to improve store merchandising, improve product knowledge, customer service and merchandising display skills of store employees through training.

4. FTE / Production Formula

If new stores are not opened and FTE's not increased in our current retail outlets, each store will continue to serve increasing numbers of customers. This means the same number of employees per store will be tasked with selling an increasing amount of inventory. This will result in declining customer service and decreasing revenue.

The following primary considerations will have a negative impact on our agency, customers and stakeholders:

- **Maximizing revenue potential.** Due to insufficient hours of operation and declining levels of service, the agency's maximum revenue-generating potential may not be reached.
- **Managed growth and future potential is diminished** by not responsibly re-investing in the enterprise. The agency is capable of giving a most favorable return on investment as proven by past performance. Given this, the return on investment carried long-term will substantially out-perform other options given to government today.
- **Increased risk to employees, customers and assets.** With inadequate staffing in stores, employees may not be able to address potential safety and security needs.

5. Pursue Reinvestment Funding Strategies

Working within the context of appropriated funding restricts management's ability to respond to market changes quickly and invest or re-invest resources as needed to maximize revenues to the state.

6. Install a Wide Area Network (WAN)

Stores currently have only a dial-up connection for credit/debit card authorizations, email, intranet access, payroll processing, lottery scratch ticket verification, and security monitoring. Dial up connections are extremely slow in today's environment. It takes 25 to 40 seconds for credit/debit card authorization compared to the industry standard of less than 1 second. A WAN will be required to accommodate the state's new HR system being implemented in 2005.

Purchasing and Merchandising

As the Deloitte & Touche Retail Business Plan emphasized, leading retailers generally use a merchandising strategy that sets the course for product selection, ordering, product allocation to stores, store layout, and shelf and category management. The WSLCB has policies and systems for product selection, purchasing, and distribution. However, no overall merchandising strategy, shelf or category merchandising programs are in place. Purchasing Services continues to use an outdated forecasting and re-order system that does not operate on modern inventory management principals.

Successful merchandising programs can generate sales and maximize margins, particularly in a changing marketplace. Input from manufacturers suggests an effective store merchandising program can increase sales between two and three percent, although the specific success rate is difficult to prove as there are many variables that impact sales trends. Each percentage point increase in annual sales equals \$5 million added to gross sales. This opportunity is supported by research that indicates the majority (66 percent) of consumer decision making occurs in the store and that today's customers make choices quickly after minimal search and price comparison. A store-merchandising program can:

Successful merchandising programs can generate sales and maximize margins, particularly in a changing marketplace. If a 3 percent increase were realized, the WSLCB's annual sales would increase by over \$15,000,000.

- Promote ease of product selection
- Encourage impulse purchases
- Optimize shopper trade-ups
- Help minimize out-of-stocks
- Make product mix decisions and inventory control easier

Initiatives in this area include:

Create a Store Merchandising Program

Basic elements of a merchandising program would include:

- Optimum product selection
- Uniformity of look in state-operated stores
- Effective category and shelf management programs
- Consistency with current design concepts
- Expanded training for store teams
- Maximum use of floor and shelf space
- Consistent and effective signage
- Flexibility in fixtures
- Explore other retail store concepts

1. Hire a Merchandising Manager

A Merchandising Manager is needed to direct this work and to work more closely with suppliers to ensure their viewpoints are being heard. This position is similar to the Wine Program Manager position created in 1996 to focus on the purchasing and merchandising of wine. Wine sales rose from \$19 million in 1996 to more than \$36 million in 2001.

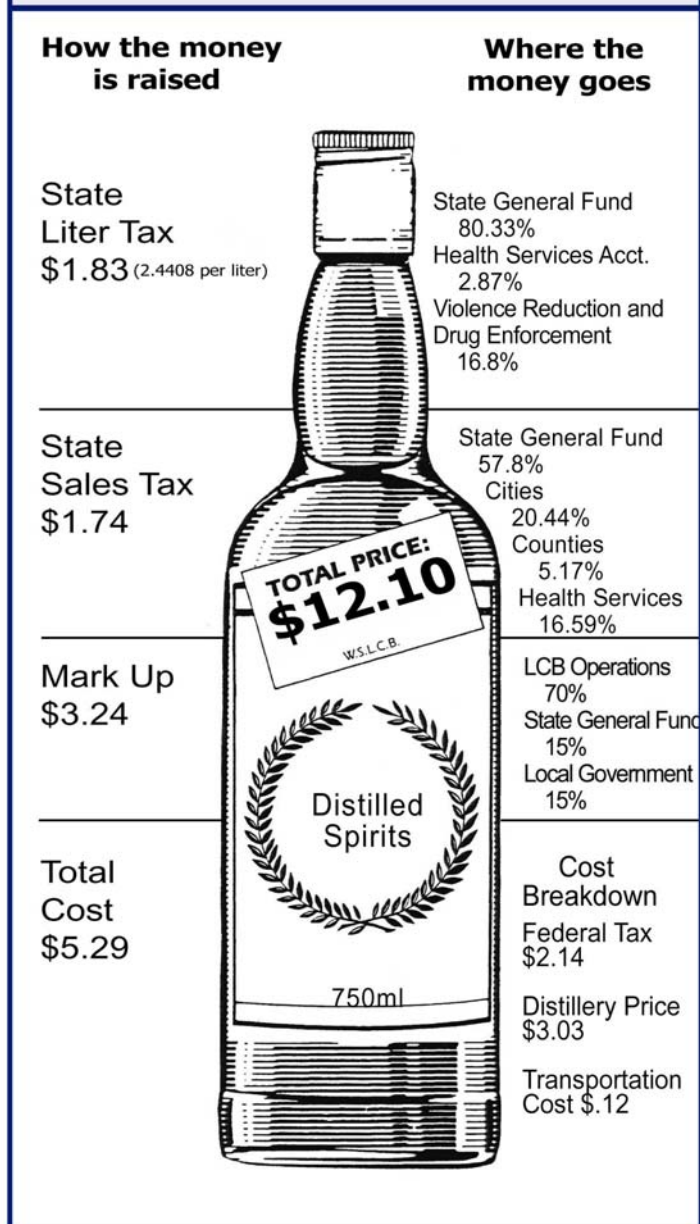
Pricing

The retail price of liquor sold in state-run and contract liquor stores is determined by five elements:

1. Distiller's, brewer's, or vintner's price to the Board
2. Federal taxes--excise tax rates on all liquor, plus custom duty rates on imported liquor
3. Freight costs
4. Markup controlled by the Board
5. State sales taxes that are set by the State Legislature

On the following page is a breakdown of how the above elements are applied to the pricing of one bottle of liquor.

Washington State Liquor Control Board
PRICE PICTURE
FOR DISTILLED SPIRITS



For wholesale accounts there is a tax exemption and a standard discount. Discount rates and tax exemptions are also established for Tribes and military establishments.

For spirits, the Board approves all new product listings, and these products have twelve months to meet profitability requirements. Spirit listings are recommended to the Board by the Purchasing Services Director, using established criteria. Wine listings are recommended to the Board by the Wine

Program Manager, with input from the Wine Advisory Committee. Wines are available for general distribution to all stores or are distributed to “hub stores,” which receive wines bought in smaller quantities and distribute to other stores in the area that may wish to sell these products. Existing products are reviewed annually to see if they meet the profitability standard for their product class.

The markup the Board establishes on products, and the resulting margins made on sales are the key determinants of the Cost of Goods Sold percentage. In conjunction with the goal of reducing the businesses Cost of Goods Sold, a review is being done to determine opportunities to increase margins on specific products to support the Cost of Goods Sold reduction goal.

Inventory Management

Inventory management is a key component of purchasing and merchandising. Knowing where stock is, what is in stock and out-of-stock, setting inventory levels, and managing inventory turns and special order programs all affect purchasing and merchandising decisions. The new point-of-sale system will improve this capability. During the next three years, managing inventory levels will be a third way of reducing the business’s Cost of Goods Sold. Results of this effort will include the following:

1. Increase Inventory Turns in State Liquor Stores

The goal is to increase inventory turns from the current 10.4 turns per year to 11.5 inventory turns per year by June 30, 2006, and to 13 inventory turns by June 30, 2007. Achieving an increase to 13 turns per year from the current 10.4 will improve working capital by \$10 million.

Distribution

The mission of the agency’s liquor Distribution Center is to ensure the timely, safe, and efficient receipt, storage, and shipment of spirits, wine, and beer to the 315 state-run and contract liquor stores and to tribal and military outlets located throughout the state.

As part of the agency’s plan to modernize the state’s liquor retail and distribution systems, the agency’s original Distribution Center was replaced with a new 160,000 square-foot facility on the existing Seattle site. The WSLCB has been operating out of the new Distribution Center since April 2002 with a new automated material handling system to process the approximately 17,000 cases of liquor shipped out of the facility each day.

The Distribution Center maintains a daily inventory level of between 400,000 and 500,000 cases of liquor, depending on peak periods. The receiving department processes receipts from approximately 330 domestic and international shippers. Local freight carriers redistribute product weekly to the 315 retail outlets. Since 2001, shipments have increased from 3,748,028 to 3,925,563 cases for 2003. This is a 4.7 percent increase in volume in 3 years. The October through December 2003 holiday period reflected a 3.8 percent increase over the same time period of 2002.

Having a reliable and responsive distribution system is essential to the success of the overall operation. As such, the following strategies have been established to support this goal:

1. Increase the Distribution Center's Capacity

The DC was designed in the early 1990s to meet an estimated one percent annual growth rate over a 20-year period. Real growth in bottle sales far outpaced this estimate. In 2002, when the DC opened, it already was operating near capacity during peak periods. By 2003, the agency had already achieved the 20-year growth level predicted a decade earlier. The DC's capacity is being stressed during the off-season and is seriously challenged during the holiday peak season. The agency now predicts sustained annual growth of 5 percent. The DC needs to be expanded this biennium or it will not be able to fully handle the WSLCB's product shipping and storage needs.

2. Achieve a Fill Rate of 96 Percent of Available Product

To accomplish this goal going forward, the staffing at the Distribution Center needs to be modified and capacity increased. Similarly, as growth occurs, the need for spare parts increases. It is also important that the Distribution Center has spare parts readily available as existing parts break or wear out. Any downtime affects deliveries and availability of stock at stores. Because the vendor is from overseas, some parts are not readily accessible. The DC has obtained an inventory of parts to be physically located at the Distribution Center.

Customer Service

1. Install a Wide Area Network (WAN)

Credit/debit card authorizations take 23 to 40 seconds to complete compared to the industry standard of less than one second. This causes lengthy delays and loss of efficiency during peak periods and holidays. These delays discourage customers from returning and leave them with a negative perception of how the state does business. Other revenue opportunities will be possible once a WAN is installed, like gift credit cards and additional lottery games, that will generate even more revenue for the state.

2. Line Buster Technology

Customer throughput in our stores can be improved with Line Buster technology. Portable scanning equipment combined with our new MBS system will help reduce long lines during the holidays and have other multiple uses.